VZCZCXRO7876
PP RUEHCN RUEHGH
DE RUEHBJ #8109/01 1180951
ZNR UUUUU ZZH
P 280951Z APR 06
FM AMEMBASSY BEIJING
TO RUEHC/SECSTATE WASHDC PRIORITY 4172
RUEATRS/DEPT OF TREASURY WASHDC PRIORITY
INFO RUEHOO/CHINA POSTS COLLECTIVE
RUCPDOC/USDOC WASHDC

UNCLAS SECTION 01 OF 02 BEIJING 008109

SIPDIS

SENSITIVE
SIPDIS

USDOC FOR DAS LEVINE AND ITA/MAC/AP/MCQUEEN
TREASURY FOR OASIA/ISA KOEPKE AND DOHNER
STATE PASS CEA FOR BLOCK
STATE PASS FEDERAL RESERVE BOARD FOR JOHNSON/SCHINDLER; SAN FRANCISCO FRB FOR CURRAN; NEW YORK FRB FOR DAGES/CLARK
STATE PASS USTR STRATFORD/WINTER/MCCARTIN

E.O. 12958: N/A
TAGS: EFIN EINV CH
SUBJECT: China Raises Interest Rates to Rein in Overheated Growth

(U) This report is sensitive but unclassified. Please handle accordingly.

¶1. (SBU) Summary: On April 27, the People's Bank of China (PBOC) announced an increase in loan interest rates, with rates on the benchmark one-year lending rate rising by 27 basis points to 5.85 percent. Local observers interpret this move as a response to fears that the economy is overheating. Statements by government officials indicate concerns over excessive investment and overcapacity. Although the increase in lending rates is modest, it sends a positive signal that the government is using market-based instruments to rein in lending. If this interest rate hike fails to have the desired effect, the government could take further steps, such as more rate hikes or an increase in reserve requirements. End summary.

Rates Up

¶2. (U) The People's Bank of China (PBOC) announced on Thursday, April 27, that effective Friday, the benchmark for one-year lending rates will rise to 5.85% from 5.58%, and deposit rates remain unchanged. According to the central bank, "The increase in the lending rate is aimed at further strengthening the fruits of macro controls and keeping solid momentum for the economy to grow in a continuous, rapid, coordinated and healthy manner." The PBOC also increased the six-month lending rate to 5.40% from 5.22%, and on loans of three to five years to 6.12% from 5.85%. Interest on loans of more than five years was raised to 6.39% from 6.12%. The PBOC last raised the lending rates in October 2004. Furthermore, the central bank posted a notice on its Web site quoting DeputyQernor Wu Xiaoling telling a meeting of executives of commercial banQnd policy banks that credit controls are needed. "We must strictly control loans to sectors that are overheating. We must ensure control of credit and prevent sharp swings in credit growth," she stated.

Overheating Fears

¶3. (SBU) This policy move is being viewed as a reflection of growing concern among China's top leaders over overheating in the economy. In the first quarter of this year, Chinese economic growth accelerated to 10.2% on an annualized basis and fixed-asset investment growth rose to 27.7%, fueled by excess liquidity in the financial system. Referring to this situation, Chinese President Hu Jintao noted in early April that "We do not want, nor are we pursuing, excessively rapid economic growth." The National Development and Reform Commission (NDRC) warned on Tuesday that annual demand for cement was 1.05 billion tons, while production capacity had reached 1.3 billion tons. Three-fifths of the capacity, moreover, was for low-quality cement that China's increasingly advanced economy no longer needs. In its notice, the NDRC called for local governments to limit new projects in a range of industries facing overcapacity, including cement, aluminum, autos, and textiles.

A Positive Signal

¶4. (SBU) In a research report Stephen Green of Standard Chartered Bank in Shanghai suggested the PBOC is trying to send a strong signal that the authorities are serious when it comes to controlling overheating in the economy and over-investment. Econoffs' contacts agree that the Chinese Government is likely to follow up with further cooling measures to drain liquidity out of the banking system such as raising reserve requirements. Chris Murck, APCO Asia CEO and Bank of Shanghai board member, doubted the interest rate move would have much impact on the exchange rate. He pointed out that ordinarily high interest rates boost currencies, but the PBOC did not change bank deposit rates. By raising lending rates while leaving deposit rates untouched, the government will allow banks to widen their profit margins, which will help cover losses on loan defaults, according to Murck. He noted that low deposit rates also encourage domestic demand, another government

goal.

¶5. (SBU) Michael Ipson, the banking specialist at IFC's Beijing office, saw the interest rate hike as a signal that China is more committed to using market-based tools to manage the economy, and believes interest rates could increase further. He noted that banks continue to underprice loans and this move will help encourage banks to lend at more appropriate rates. In his view, if the interest rate hike and PBOC jawboning fail to cool excessive lending, the central government will take additional measures, including an increase in reserve requirements.

Administrative Controls?

¶6. (SBU) Professor of Economics Zhao Xijun of Renmin University suggested the hike is too small to have much impact on lending decisions. "The move is incremental at most, and it did not work to slow investment last time when the central bank raised interest rates back in 2004," Zhao noted. He expects, however, regulators will shortly pass instructions to managers of large state-owned banks to lend less. Ipson of IFC believes the Government will only use administrative controls as a last resort.

Comment

¶7. (SBU) Although the 27 basis point interest rate hike is modest, it signals that China increasingly is willing to allow markets play a greater role in shaping the economy, although directives from the central government may still play a prominent role. The adjustment also reflects a greater sophistication of financial policymaking in line with China?s new status as the world's fourth-largest economy. In the past, Chinese officials have turned instinctively to bureaucratic measures to restrain growth, before utilizing market-oriented instruments such as interest rates.

Sedney